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In The

Supreme Court of the United States

October Term, 1998

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Petitioners,

vs.

COMMONWEALTH OF VIRGINIA, *ex rel.* MARK EARLEY, Attorney General of the Commonwealth of Virginia; MARK EARLEY, Attorney General of the Commonwealth of Virginia and The Commonwealth's Attorney for the City of Alexandria,

Respondents.

On Petition for Writ of Certiorari to the Virginia Supreme Court

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether the Virginia Supreme Court correctly decided that the Petitioners breached their fiduciary duty as Trustees-in-dissolution pursuant to the law of Maryland, which law the Virginia Supreme Court found to be totally consonant with the law of Virginia.

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BASIS FOR JURISDICTION

The Respondents deny that the jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(1).

STATEMENT OF THE CASE

A. Introduction.

The Petitioners[1], in the face of a clear admonition from Virginia's highest court, continue their attempt to annul the factual findings upon which the judgment below rests. These findings were amply supported by the overwhelming weight of the evidence, which the Virginia Supreme Court found was largely created by the Petitioners themselves. It is abundantly clear that Petitioners can lodge no good faith assertion that they carried out any "corporate reorganization under Maryland law", by which a charitable hospital was merged into a for-profit corporation. The Virginia Supreme Court affirmed the trial court's finding that no such transaction ever occurred. What is clear from this record is that a whole series of complex and conflicting transactions took place under the Petitioners' direction consistent with ". . . discussions among [Petitioners] as to their personal profits and gains with no reference to the best interests of the beneficiaries nor of the charitable corporation." 16A.[2]

Petitioners misconstrue the clear and succinct findings of the Virginia Supreme Court. Upon a scholarly application of Maryland law, Virginia's highest court determined that, with Maryland's revocation of the charitable corporation's charter,

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1. Also referred to herein as the "Physicians."

2. Numbers preceding the letter "A" denote references to the Appendix to the Petition.

the charity's assets which had been impressed with a public trust passed to its directors as common-law trustees. The trustees' sole remaining authority was to expeditiously wind-up the corporation's affairs and to distribute its assets in accordance with its charitable purpose. The Virginia court specifically held that the internal affairs doctrine did not apply to the Petitioners' actions taken after the corporate termination because ". . . there was no corporation for which to act." 11A. Therefore, under these circumstances and in reliance upon Maryland law, the Virginia Supreme Court further concluded that this case did not involve

> . . . improper meddling by the Commonwealth into the internal affairs of a Maryland corporation, contrary to settled law and violative of the Full Faith and Credit, Due Process, and Commerce Clauses of the United States Constitution.

10A. Ignoring these clear and concise findings which were supported by the totality of the record evidence, Petitioners seek to create an issue that simply does not exist.

The actions of these Petitioners demonstrate an abuse of the privileges and immunities that are granted to charitable corporations as favored institutions in the United States. The course of conduct described in this record has been condemned as violative of the fairness required of those entrusted with assets that are impressed with a trust for the benefit of the public. The record amply and without contradiction shows that these Petitioners converted the charity's public nature and purpose into a vehicle for their own personal pecuniary gain. In this case, the overreaching by these Physicians, who excluded all public participation from the Board of Directors, was so egregious that ". . . the result was the total obliteration of the non-profit corporation." 16A.

B. The Facts Found Below.

In stating their case, the Petitioners fail to disclose to this Honorable Court certain controlling facts found by the trial court and reiterated by the Virginia Supreme Court. These facts entirely refute the Physicians' Petition by establishing the dissolution of the subject corporation and the absence and impossibility of any subsequent internal affair. Pointedly, the Petitioners avoid a direct discussion of either the validity or timing of the corporation's alleged "reorganization". This case simply involves actions taken by the Physicians in total derogation of their duties under the laws of both Maryland and Virginia, and in violation of the charter of the not-for-profit, charitable hospital of which they were the directors.

Jefferson Memorial Hospital, Inc. ("JMHI"), originally was chartered as a for-profit corporation in the state of Maryland and subsequently amended its charter to a charitable, non-profit form when it opened in Virginia as an acute-care hospital on March 15, 1965 and obtained tax-exempt status pursuant to section 501(c)(3) of the Internal Revenue Code. JMHI remained in existence only until 1973, at which time Maryland revoked its charter for failure to file its annual report. At no time was JMHI's corporate existence revived.

Throughout the duration of its existence, JMHI maintained extensive contacts with the Commonwealth of Virginia. JMHI was licensed by the Commonwealth of Virginia as an acute care hospital. JMHI's physicians and primary health-care givers also were licensed by, and were under the supervision and control of, the Commonwealth of Virginia. Virginia law, both then and now, specifically prohibited the transfer of an acute-care hospital license. The hospital's census was derived almost exclusively from residents of the Commonwealth of Virginia. On numerous occasions, JMHI pleaded charitable immunity in

defense to lawsuits, which immunity previously had been granted by the Virginia General Assembly to charitable hospitals sued for negligence. The record indicates that JMHI sought and received relief from taxation and received other benefits as a result of its operations which were conducted totally within the Commonwealth.

The Physician Petitioners served as the charity's board of directors throughout its lifespan and, at all times, precluded any outsiders from creating a disinterested presence on the board. From 1965 to 1973, the Physicians intentionally organized JMHI as a severely undercapitalized corporate shell and reserved to themselves ownership of virtually all operating assets, including its building. By owning the assets in a succession of partnerships, the Physicians, without any consideration of fairness, ensured to themselves an ever-growing equity of ownership by leasing the operating assets to the hospital. The rental payments amortized the funds which they had borrowed to acquire the assets and paid them a guaranteed profit on their investment. Without regard to fairness or corporate formality, the Petitioners shifted the assets at will to whichever entity most benefitted them personally at any point in time. So pervasive was their failure to adhere to the law that they purported to have carried out transactions, such as corporate reorganizations, that specifically were prohibited under the law of the state of Maryland, for which they so earnestly contend.

As early as October, 1966, disinterested counsel employed by the Physicians examined the structure of the insiders' transactions and warned that:

> Such an extraordinary situation invites extraordinary challenges of Federal and local authorities which we cannot anticipate at this time, but you must be

willing to risk. Title itself to the hospital building may be challenged by a lending institution or some other party.

On April 4, 1969, approximately two-and-a-half years after counsel's prediction, the Internal Revenue Service began examining JMHI. The IRS determined that these transactions constituted such a patent breach of trust that it commenced an investigation which culminated in the revocation of JMHI's tax-exempt status. The extreme degree of private inurement inherent in the Physicians' many insider transactions was recognized by the IRS within a mere three years after JMHI's qualification as a tax-exempt organization. Experts testifying for both parties in this case acknowledged that revocation of Section 501(c)(3) status was extremely rare.

In January, 1972, the IRS revoked JMHI's tax-exempt status, retroactive to January 1, 1966. In so doing, the IRS specifically found that the Physicians' own inappropriate conduct was the direct cause of the revocation of JMHI's charitable status. As a result, the IRS levied assessments against a limited partnership controlled by the Physicians.

In 1970 and 1971, while faced with the impending revocation of JMHI's charitable status, the Physicians, without any corporate formality, caused JMHI to relinquish its on-record majority ownership interest in the hospital land and wrongfully appropriated JMHI's charitable assets for the benefit of a for-profit corporation whose shares they wholly owned. These actions were taken under the guise of a contemplated merger between JMHI and a for-profit Delaware corporation wholly-owned by the Physicians, which merger was designed to insulate the Physicians from personal liability and to facilitate an anticipated public stock offering on Wall Street. The counsel retained by JMHI's directors indicated that if the hospital

continued as a charity, the Physicians would be operating a for-profit corporation within the framework of a non-profit structure. Counsel described this as an "unwieldy" situation and warned that continued confusion would exist with respect to tax treatment and, most importantly, indicated:

> In my opinion, there is a very real danger that an individual suing the hospital on a malpractice or other tort action might persuade the court to disregard the alleged corporation and treat the organization as a whole, as a partnership. In such a case, each of the members, officers and directors, would be individually and collectively liable as general partners.

Thus, the record created by the Petitioners clearly debunks the statement that the Physicians were "a group of dedicated doctors" who put their ownership of the hospital's operating assets at risk to provide the hospital with much-needed operating capital. What the record does disclose, however, is that their veil of corporate existence was so diaphanous and ephemeral as to expose them to personal liability. In addition, it is obvious that all of the actions were undertaken for the purpose of enriching the Physicians and avoiding personal exposure to liability for medical malpractice suffered by their own patients.

Petitioners' statement that they complied fully with the corporate laws of Maryland is disingenuous in the extreme. Maryland law directly prohibited the very transaction that Petitioners claim they carried out. There is no good faith basis for Petitioners' assertion that any legally cognizable basis existed for the unlawful conversion of the charity's assets by its directors. The Petition fails to disclose to this Court that the putative merger never occurred and legally could not have occurred. The Petition further fails to acknowledge that the

uncontradicted evidence clearly confirms the Physicians' contemporaneous knowledge that no merger ever occurred and that they were operating without legal authority. In fact, as found by the trial court, the Physicians, knowing that their Maryland charter had been revoked, falsely represented to Virginia officials that the Maryland charitable corporation was in good standing. As the trial court further found, no Plan of Merger was ever approved, the requisite disclosures were never filed with either Maryland or Virginia, and the purported consideration was never issued. Despite knowledge of such facts, the Physicians assumed dominion and control of JMHI's assets, and intentionally represented to state and federal tax authorities that the merger had occurred. Improperly claiming this putative merger on its tax returns, however, permitted the new for-profit corporation to take advantage of several hundred thousand dollars of non-transferrable loss carry-forwards that belonged to JMHI.

Importantly, all jurisdictions having any interest in the purported merger proscribed the merger of stock and non-stock corporations. Virginia, Maryland and Delaware each recognized that members and directors of a not-for-profit charity have no claim to ownership of the charity's assets that can form the basis for the issuance of stock to themselves in order to effect a merger or reorganization into a for-profit corporation.

The trial court found that the alleged merger was a complete fiction and that the Physicians' certification of it to state and federal tax authorities was utterly false. The trial court could not excuse the total lack of corporate formality and refused to create a merger specifically proscribed by positive law. Additionally, because Virginia law (Va. Code Ann. § 32-299(2)), both then and now, prohibited transfer of a hospital's operating license, a contrary ruling by the trial court would have approved operation of the hospital by an unlicensed entity not qualified to do business in Virginia.

After 1971, the Physicians abandoned JMHI by failing to conduct meetings, by failing to file annual reports and by ignoring its existence. In April, 1973, as a result of these failures, the state of Maryland terminated JMHI's corporate existence. After that date, Maryland law proscribed JMHI's directors from transacting business on behalf of the charity.

Also in 1973, the Petitioners had exhausted all of the net operating losses arising from JMHI's loss of charitable status and, the record is clear, yearned to recapture the substantial tax benefits and profits that they had enjoyed previously when they held the assets in their various partnerships. To carry out their desire, the Physicians recreated the asset ownership structure that they had employed prior to the revocation of JMHI's 501(c)(3) status and prior to the illegal transfer of the charity's assets to their for-profit corporation. In complete disregard of the fact that the charity's corporate existence had been extinguished, the Physicians retained counsel in 1974 in an attempt to legitimize the transfer of assets from JMHI to their for-profit corporation. They state that they retained counsel to ensure that the hospital's corporate structure for the past, present and the immediate future was legally correct. However, board minutes reflect that the true purpose was to protect the board members as investors rather than to protect the corporation's interests. Counsel testified at trial that the Physicians informed him neither of the termination of JMHI's corporate charter nor of the earlier purported transfer of assets from JMHI. Counsel then proceeded to document a series of transactions wherein the assets of the former charity were to be acquired by the same for-profit corporation that allegedly already had acquired these assets. Counsel purported to conduct a series of stockholder and board meetings of the then-defunct JMHI using records from 1965 to determine the identity of members and directors, uninformed that there had been substantial changes since that time. Within a matter of minutes,

JMHI's alleged insolvency was declared and the transfer of assets approved. The actions purportedly authorized by the Petitioners in 1974 were entirely inconsistent with and totally contradicted any assertion that a merger occurred in 1971. In fact, in 1974, the directors no longer held authority to conduct the very transaction upon which they now seek to stamp the judicial system's imprimatur.

The overwhelming body of evidence demonstrates beyond doubt that the conspicuous self-dealing by the charity's directors, undertaken after JMHI's dissolution, occurred in derogation of the directors' positive duties as common-law trustees in liquidation under the laws of Maryland. After dissolution of the charity in 1973, the Petitioners were charged with the duty to liquidate and distribute the charity's assets in accordance with the public trust to which the assets were dedicated. The overwhelming majority of the beneficiaries of this public trust were the citizens of the Commonwealth of Virginia, where the hospital and its assets were located and operated. The Petitioners' failure to execute their duties as trustees and to honor the public trust entitles the beneficiaries to the protection and preservation of the assets so dedicated.

REASONS FOR DENYING THE WRIT

I.

RESOLUTION OF THIS MATTER IN THE STATE COURT DID NOT INVOLVE ISSUES ARISING FROM THE FULL FAITH AND CREDIT, DUE PROCESS OR COMMERCE CLAUSES OF THE UNITED STATES CONSTITUTION.

The Commonwealth of Virginia has little quarrel with Petitioners' recitation of judicial precedent regarding the

internal affairs doctrine. Such body of law, however, has no application to the facts of this case. The Physicians' true argument presented before this Court does not concern the application of law; rather, they disagree with the facts meticulously found by the trial court and affirmed by the Virginia Supreme Court. Even assuming, *arguendo*, that the misappropriation of charitable assets by the board of directors of a not-for-profit corporation did constitute an internal affair of JMHI, the Virginia courts resolved all controverted issues by scrupulously adhering to Maryland law. Any controversy that presently exists results from the Physicians' intractable insistence, in the face of overwhelming contrary evidence, that a legally prohibited reorganization or merger occurred on some unspecified previous date. Petitioners argue that the state of Maryland would sanction their appropriation of the charity's assets to their own use under circumstances in which their self-dealing was so offensive that it resulted in the revocation of tax-exempt status. In so arguing, however, they ignore certain fundamental findings of fact by the trial court. They ignore the finding that their self-dealing was so egregious as to result in the total obliteration of the charity. They ignore the finding that there was a total absence of even a marginal attempt to comply with corporate formalities required by the state of Maryland, whose law they now seek to assert has been ignored. Most importantly, they refuse to acknowledge the finding that the alleged merger, reorganization or transaction (or whatever description they presently utilize) was specifically prohibited by Maryland statutes then, and still, in full force and effect.

In short, the Virginia Supreme Court's decision in this case was clearly based on separate, adequate and independent state grounds. That court dismissed the Petitioner's argument that the Commonwealth of Virginia improperly meddled into the internal affairs of a Maryland corporation in violation of the Full Faith and Credit, Due Process and Commerce Clauses of

the United States Constitution. The court stated several reasons for its determination. First, with regard to the trial court's finding that no corporation existed at the time of any alleged transaction, the Virginia Supreme Court concluded that, because the directors became trustees upon the corporation's dissolution, Maryland corporate director's conflict-of-interest law did not apply. Second, the court applied Maryland statutory and case law with regard to corporate dissolution and the public trust doctrine of charitable corporations and affirmed the trial court, importantly noting that the outcome would have been the same regardless of which jurisdiction's law was applied. Thus the Virginia Supreme Court applied the appropriate state law to causes of action that rightfully are decided under state law. Therefore, no federal issue was involved in the decision.

This Court has on many occasions expressed its "respect for the independence of state courts" and its aversion to rendering advisory opinions in cases in which there is an adequate and independent state ground for decision. *Michigan v. Long*, 463 U.S. 1032, 1040 (1983). This Court will not under take to review a state court decision "if the state court decision indicates clearly and expressly that it is alternatively based upon bona fide separate, adequate and independent state grounds." *Id.* at 1041. Here, as in the Virginia Supreme Court, the Petitioners attempt to fashion a federal issue where none exists. The Petitioners have failed to raise any federal grounds on which this case should have been decided, outside of their purported violations of the Full Faith and Credit, Due Process and Commerce Clauses of the United States Constitution, which the Virginia Supreme Court accurately found not to have existed. The Virginia Supreme Court not only made a plain statement of the absence of federal considerations, it clearly applied Maryland law to the issues presented below and found Maryland law to be in complete accord with Virginia law. Therefore, this case presents no federal issue that would need to be decided were this case to be relitigated upon remand.

The Physicians' Full Faith and Credit, Due Process and Commerce Clause arguments stem from their inaccurate assertion that, by the trial court's purported refusal to apply Maryland director conflict of interest statutes and fiduciary duty law, the Commonwealth of Virginia improperly meddled in the internal affairs of a Maryland corporation. The Virginia Supreme Court correctly ruled that it could entertain such arguments only by ignoring the trial court's ruling that no corporation existed at the time of the alleged transaction upon which the Petitioners stake their claims. The Virginia high court rejected the Petitioners' continued attempts to ignore the trial court's ruling, based upon Maryland law and "fully supported by applicable law and the uncontradicted evidence, most of which was created by defendants," (10A) that no merger occurred between JMHI and the Petitioners' for-profit corporation; that the post-1973 actions by the directors of JMHI were void; that JMHI's assets remained under its ownership until its dissolution; and that upon JMHI's dissolution, the assets passed into the hands of the Petitioners as trustees for the public benefit. Maryland General Corporation Law Art. 23, § 78(a) (1957); *Cloverfields Improvement Ass'n v. Seabreeze Properties, Inc.*, 373 A.2d 935, 939-40 (Md. 1977); *Inasmuch Gospel Mission, Inc. v. Mercantile Trust Co. of Baltimore*, 40 A.2d 506, 510 (Md. 1945). Having had its charter revoked, JMHI lost its corporate existence and powers and therefore could no longer function ~~as~~ a corporation. *Cloverfields Improvement Ass'n v. Seabreeze Properties, Inc.*, 362 A.2d 675, 679 (Md. App. 1976). Therefore, with no corporation in existence, there could be no directors subject to the fiduciary duty laws of the state of Maryland.

The opinion of the Virginia Supreme Court, even under the most tortuous reading, cannot be said to have ignored Maryland law as the primary basis for decision. Both the trial court and the Virginia Supreme Court considered the question

and properly determined that Virginia and Maryland law were in accord with respect to all controverted issues. Both lower courts cited Maryland law as authority for their holdings that the 1973 revocation of JMHI's corporate charter terminated JMHI's corporate existence and powers, made on-going corporate functions illegal, converted JMHI's directors by operation of law into trustees-in-dissolution and required distribution of the charity's assets in accordance with the public trust with which they were impressed.

II.

THIS APPEAL DOES NOT PRESENT REAL OR SUBSTANTIAL FEDERAL ISSUES.

The opinion below leaves little doubt that Virginia's courts believed that the improprietous acts of these Petitioners were equally contemptuous and sanctionable under the laws of both jurisdictions. Even had the opinion below applied Virginia law without reference to Maryland authorities, it is respectfully submitted that jurisdiction of this matter by this Honorable Court should not be entertained. This Honorable Court entertains cases arising in state courts only where these decisions present federal issues that are "real and substantial." This United States Supreme Court has clearly held that it does not "review federal issues that can have no effect on the state court's judgment." *Intern. Longshoreman's Ass'n, AFL-CIO v. Davis*, 476 U.S. 386, 387 (1986). The Court is not permitted to render an advisory opinion, and if the same judgment would be rendered by the state court after it corrected its views of federal laws, its review could amount to nothing more than an advisory opinion. *Herb v. Pitcairn*, 324 U.S. 122, 126 (1945). It is clear that the laws of both states are identical on these issues and that a resolution under either set of laws would render the same outcome. It does not serve judicial economy to visit

federal issues under circumstances in which such review would result in no effect upon the decision already rendered.

Further, Petitioner's assertions of Due Process[3] and Commerce Clause violations in this case are not independently sufficient to confer jurisdiction upon the United States Supreme Court to grant certiorari in this matter and must fail for the same reasons as does Petitioner's Full Faith and Credit argument. This Honorable Court has refused to extend its jurisdiction to cases where such claims are so "wholly unsubstantial and frivolous as to be devoid of any merit." *Bowe v. Scott*, 233 U.S. 658, 665 (1913). *See also Willamson v. Hopewell Redevelopment & Housing Authority*, 371 U.S. 234 (1963); *Bell Telephone Co. of Pennsylvania v. Pennsylvania Public Utility Commission*, 309 U.S. 30 (1940). Inasmuch as the purported violations asserted by Petitioners stem from an erroneous assertion that the Virginia Supreme Court refused to apply Maryland law, Petitioners' arguments are meritless, especially under circumstances in which it is clearly established that no different result would obtain from a review by this Honorable Court. An appeal asserted under such circumstances involves no federal issue of merit.

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3. Though unnecessary for this decision, even had the Virginia Supreme Court not applied Maryland law, the Petitioners would not have experienced a denial of due process of law. The contacts that the Physicians and JMHI maintained with the Commonwealth of Virginia were of such an extensive and pervasive nature that the application of Virginia law to their conduct could be neither unexpected, arbitrary nor fundamentally unfair.

CONCLUSION

The opinion rendered by the Supreme Court of Virginia properly applied Maryland law with respect to the resolution of all contested issues of fact and law. The decision appealed from addresses no internal affair of the charitable corporation. Rather, the court correctly determined, pursuant to Maryland law, that upon termination by Maryland authorities of the charitable hospital's corporate existence, the charity's directors became trustees-in-dissolution and were charged with the sole duty of winding up corporate affairs and appropriately distributing assets. This they failed to do. The Supreme Court of Virginia rejected as a "tactic" the Petitioners' urging of the court to annul properly supported factual findings and, thereby, to create an otherwise non-existent federal issue. Respondents respectfully submit that the Petitioners here repeat their previous attempts and pray that this Honorable Court deny the Petition for a Writ of Certiorari.

Respectfully submitted,

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